

Options for Revising the California Tax System

*California Commission on Tax Policy
in the New Economy*

June 15, 2003

California Commission on Tax Policy in the New Economy

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TO: The Honorable Gray Davis, Governor

FROM: William J. Rosendahl
Chairman, California Commission on Tax Policy in the New Economy

RE: *Options for Revising the California Tax System*

DATE: June 15, 2003

On behalf of the Commissioners and Ex-Officio members of the California Commission on Tax Policy in the New Economy, I am pleased to present *Options for Revising the California Tax System*.

As the year 2003 began and the economic crisis facing California deepened, you appeared before the Commission on February 3rd and requested our assistance. Recognizing the Commission could play the role of an honest broker and provide a safe haven for robust discussions throughout the full political spectrum, you encouraged us to explore a variety of options for changing California's tax system, and to offer constructive ideas on budget structural reform.

This report further develops the themes contained in our *Interim Report*, dated November 25, 2002, and expands the debate surrounding those very issues for which you sought guidance and counsel. Our Commission is ideally situated to frame the public debate to follow, through an intensive outreach to all constituencies and citizen groups. We are especially enthused about the opportunities to work with key Legislature Committee Chairs and their staffs to facilitate reaching bipartisan agreements.

We are here to serve you and all Californians in this important task. We will keep your staff informed of our proceedings and will gladly respond to any additional requests you may have.

Respectfully submitted,

William J. Rosendahl
Chairman

CC: Members of the California Senate and Assembly
California Commission on Tax Policy in the New Economy

ACKNOWLEDGEMENTS

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INTRODUCTION

On September 23, 2000, Governor Gray Davis signed into law SB 1933 (Vasconcellos), establishing the California Commission on Tax Policy in the New Economy. The Commission was directed to identify key stakeholders in the new economy, conduct public hearings, develop a comprehensive agenda of goals and critical issues in order to achieve long-term tax policy solutions, examine all aspects of the current and future California economy with special attention to the influence of new technologies, and assess the impact of the evolving California economy on public revenues with special attention to the needs of local governments. The Commission was also directed to study and make recommendations regarding specific elements of California's state and local tax system, including, but not limited to, sales and use taxes, telecommunications taxes, income taxes, and property taxes.

The enacting legislation, as amended by SB 934 (Sher), requires the Commission to submit an Interim Report not later than December 1, 2002, and a Final Report not later than December 31, 2003. The Commission conducted six public hearings in 2002 in Sacramento, Sunnyvale, Santa Monica, Bakersfield, San Diego, and Redondo Beach. In accordance with its statutory obligations, an Interim Report was issued on November 25, 2002.

The downturn of the California economy and its impact on tax revenues led Governor Davis, at a February 3, 2003 appearance before the Commission, to suggest that the Commission consider releasing a second, non-mandated interim report. In addition to the short-term need to develop a budget for the upcoming fiscal year, state policymakers are grappling with the long-term issue of structural reform of the state's fiscal structure.

The Commission agreed that a report issued in June 2003 could be helpful to policymakers as an outline of tax policy options being considered by the Commission. The Commission may also be able to help define the parameters of what constitutes "good" tax policy, based on a set of guiding principles. The report will outline the Commission's work plan for the rest of 2003 and advise the public and policymakers of the process it intends to use to arrive at the Final Report's recommendations.

In response to the Governor's request and the growing sense of urgency about the need for structural reform, the Commission has undertaken an aggressive agenda. In lieu of meeting every two months, as was the practice in 2002, the Commissioners met six times in the Spring of 2003. Realizing that success will lie with a non-partisan approach, an outreach to Legislators and elected Constitutional Officers of both parties was initiated. The Commission aspired to be an honest broker for all viewpoints along the political spectrum and offered a safe haven for those viewpoints to be discussed critically, without partisan rancor. A listing of those appearing before the Commission is included in the Appendix.

As a sound foundation on which to consider changes in tax policy, the Commission has consulted a blue ribbon panel of experts from previous commissions and plans to build on reports from groups such as the California Economic Strategy Panel, the Speaker's Commission on State and Local Government Financing, the Speaker's Commission on Regionalism, the Constitution Revision Commission, the Governance Consensus Project, the State Municipal Advisory Reform Team, and the Commission on Building for the 21st Century.

The Commission will conduct hearings throughout the remainder of 2003. Participation in this process by California citizens is strongly encouraged and desired. Forums where citizens can provide their ideas and comments about the tax and revenue policies that most affect their daily lives will greatly facilitate the Commissioners' ability to gain a broader perspective. On behalf of the Commissioners, an invitation is extended to all Californians to work as equal partners with the Commission in developing fair and equitable tax and revenue programs that will guarantee a high quality of life for all Californians. Attention is invited to the Commission's website where hearing locations, agendas, and the 2002 Interim Report are posted: <http://www.caneweconomy.ca.gov>.

FRAMEWORK FOR ANALYSIS

In determining its recommendations to alter California tax policy, the Commission is committed to evaluating tax policy within a framework of general principles of taxation. The Commission's objective is not to find new sources of revenue for California but to ensure that the State's tax structure meets the requirements of these guiding principles as well as the requirements of the new economy in which we live. In a broader context, fiscal and tax policy should consider both sides of the revenue dynamic:*

- (1) the reasonableness of the tax source, and,
- (2) the appropriateness of its dedicated use, such as the accountability for use of revenues, the alignment of revenues and responsibilities, and the return on investment.

This report presents various options for changing California tax policy. For each option, the report provides background information, the type of action required for the proposal to be implemented (such as statutory, regulatory or constitutional amendment), and the effect of the proposed option on the balance of local and state authority. Then an analysis of pros and cons of the option is presented, organized using the three categories of guiding principles listed below. Analyzing the tax policy options in this manner will help define the parameters of the debate around each proposal. In the appendix, the Commission is proposing a number of structural reforms to the state budget process.

In its 2002 Interim Report, the Commission adopted the ten tax principles described by the American Institute of Certified Public Accountants (AICPA).[†] The Commission has grouped these principles into three major categories: Fairness and Perception, Simplicity, and Efficiency and Balance.

FAIRNESS AND PERCEPTION

1. **Fairness and Equity:** Similarly-situated taxpayers should be taxed similarly. Equity refers to both horizontal and vertical equity. Horizontal equity describes the concept that taxpayers with equal ability to pay should pay the same amount of tax. Vertical equity means that taxpayers with a greater ability to pay should pay more tax.
2. **Transparency and Visibility:** Taxpayers should know that a tax exists, how the tax will be administered, and when it will be imposed upon them and others. The taxpayer should also know for what purpose the revenues will be used.
3. **Minimum Tax Gap:** A tax should be structured to minimize noncompliance.
4. **Neutrality:** The impact of taxes on business and consumption decisions should be kept to a minimum.

* This framework has been adopted by the California Economic Strategy Panel and previous California Commissions considering reform measures.

[†] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," New York: Tax Division of the American Institute of Certified Public Accountants, 2001.

SIMPLICITY

5. **Certainty:** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
6. **Convenience of Payment:** A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
7. **Economy of Collection:** The costs to collect a tax should be kept to a minimum for both the government and taxpayers. Appeals should be handled fairly, easily and quickly.
8. **Simplicity:** The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

EFFICIENCY/BALANCE

9. **Economic Growth and Efficiency:** The tax system should not impede or reduce the productive capacity of the economy.
10. **Appropriate Government Revenues:** The government should be able to determine how much tax revenue will likely be collected and when. Tax systems must provide adequate, reliable revenues for both state and local governments.

COMMISSION SCHEDULE 2003

The Commission will continue to solicit both expert and public testimony throughout 2003 as it prepares its final report. Now that the Commission has identified a list of possible options for revising California tax policy, it will organize its future meetings around discussions of these options.

| July – August | September – October | November – December |
|--|--|---|
| Commission Discussion and Public Hearing | Commission Discussion of Recommendations and Public Hearings | Commission Discussion and Adoption of Recommendations |

The Commission proposes to focus each of its next meetings around one or more of the following tax systems:

- Sales and use taxes;
- Property taxes;
- Income taxes; and
- Telecommunications and other business taxes.

At their July 18, 2003 meeting, the Commissioners will participate in a joint exercise to evaluate each of these existing tax systems using the AICPA guiding principles. The rating system to be used was developed by the Tax Policy Group of Joint Venture, Silicon Valley Network.* Using Joint Venture's approach, the tax system or question being analyzed is rated against each of the guiding principles of taxation. The key to the rating system is:

| <i>Rating</i> | <i>For the Item being Evaluated</i> |
|---------------|---|
| + | This principle is satisfied. |
| - | This principle is not satisfied. |
| N/A | This principle is not affected |
| +/- | Some aspects meet the principle & other aspects do not. |
| ? | Unknown |

The July 18, 2003 meeting will be held in the Los Angeles area. The remaining meetings will be held at different locations throughout the State to ensure the maximum amount of public access. The Commission may add additional meetings as warranted, and may also hold meetings near the end of the process primarily for discussion among Commission members.

The Commission will solicit expert testimony around the topics listed above, will continue to ensure time is available during each meeting to receive public testimony, and will set aside time for Commissioners to engage in in-depth discussion around its possible recommendations. For its final report, the Commission intends to develop an implementation plan for any recommendations it makes.

* Joint Venture, Silicon Valley Network's *Tax Principles Workbook*, a tool for critiquing tax and fiscal proposals and systems, is available on-line at <http://www.jointventure.org/taxpolicyworkbook/index.html>.

LIST OF TAX POLICY OPTIONS

The following tax policy options are currently under discussion by the Commission. Public comment and input are welcome. The Commission will make recommendations in its final report in December 2003.

SALES TAX

1. PARTICIPATION IN THE STREAMLINED SALES TAX PROJECT

Proposal: Encourage the legislature to pass and the Governor to sign legislation authorizing California's participation as a voting member in the Streamlined Sales Tax Project (SSTP).

Background: The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project's proposals include tax law simplifications, more efficient administrative procedures, and utilizing emerging technologies to substantially reduce the burden of tax collection. When a minimum of ten states that impose sales taxes and represent 20 percent of the U.S. population have amended their laws to comply with the SSTP's final product, the Project's participants will petition Congress to address the issue of remote sales. Hopefully, this process will conclude with a level playing field for remote sellers and brick-and-mortar firms – those firms with a physical presence in California – with regard to the collection of sales and use taxes.

There are three levels of SSTP participation: public participation, observer, and voting participant. California currently has observer status; legislation to attain voting status is being considered by the California Legislature (SB 157). If California were to become a voting member, the next step would be to decide whether to implement the agreement by amending California's sales and use tax laws to comply with the SSTP.

More information on the SSTP can be found at the following websites:

<http://www.geocities.com/streamlined2000>
<http://www.nga.org/nga/salestax/1,1169,,00.html>

Type of Action Required: Statute, Administrative

Balance of State/Local Authority: Although California has separate tax rates at the state and local level, there is a uniform tax base for the taxation of retail sales.

| 1. Participation in the Streamlined Sales Tax Project (SSTP) | | |
|---|---|---|
| Guiding Principle | Pro | Con |
| Fairness | Remote sellers currently are not required to collect state sales taxes while those retailers with a physical nexus in the state are required to collect such taxes. By streamlining the sales tax, the SSTP agreement will help move towards a more level playing field between remote sellers and firms with physical nexus. | <p>California is one of the largest economies in the world; yet, under the SSTP, California would have one vote and would be buying into a proposal that is 85 percent complete. California would be joining the SSTP too late to influence the process.</p> <p>Participation in the SSTP in and of itself will not level the playing field by allowing for the taxation of all remote sales. Implementation will still require federal approval. Real fairness will prevail when this matter is addressed by the Congress and becomes a national policy.</p> |
| Simplicity | Currently there are approximately 7,500 different sales tax collection districts in the United States, all using a wide variety of rates and definitions. The Project's goals are to provide uniform definitions, rate simplification, ease of administration, simplified exemptions, and uniform audit procedures. | <p>Conforming California's laws to the SSTP will require an overhaul of California's sales and use tax system.</p> <p>Under the SSTP, legislatures choose what is taxable or exempt in their state. However, participating states must agree to use the SSTP's common definitions for key items in the tax base. There are definitional differences between California law and the existing SSTP definitions. To conform to the common definitions, some products currently exempted from taxation in California might have to be taxed, or alternatively, some products currently taxed would be exempted.*</p> <p>The entire sales tax system must be brought into compliance with the SSTP, not just that for remote sellers.</p> <p>SSTP would still allow different tax rates. Exemptions would still allow states to have 50 different codes.</p> |
| Efficiency | <p>Compliance with the SSTP's final product will allow for a more predictable sales tax base since it will stop the leakage resulting from the growth of remote sales.</p> <p>Administrative burdens on the state will be decreased.</p> <p>The SSTP has resulted in the development of software and technology models to aid in the administration of sales and use tax collection.</p> <p>These changes would decrease consumption distortions and allow for the possibility of decreasing the sales tax rate, which would reduce the excess burden of the tax.</p> | <p>Conformity with the SSTP will not necessarily result in additional taxes being collected and will not stop the leakage resulting from remote sales growth. Only if Congress enacts a federal statute authorizing states to compel the collection of state sales and use tax by out-of-state retailers will states be able to impose and obligate the collection of taxes.</p> <p>Businesses would be burdened with identifying the location of the purchaser.</p> |

* One example of a consumer product whose tax status might have to be changed if California were to conform to the SSTP is drugs. In California, prescription drugs are currently exempted from sales tax and over-the-counter drugs are taxed. As a general rule under the SSTP, all drugs would have to either be taxed or exempted.

2. IMPROVE COLLECTION OF THE USE TAX ON REMOTE SALES

Proposal: Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.

Background: What is commonly thought of as “the sales tax” includes both sales and use taxes. “Sales taxes” apply to retail transactions that occur within a state, while “use taxes” must be paid by buyers who use, consume, or store in-state items that were purchased out of state. States require sellers to collect sales tax on taxable sales* and remit the tax to the states for transactions within an individual state’s borders. If products are shipped to nonresident purchasers, the seller is not required to collect sales tax, but purchasers are supposed to pay the use tax in their home state.

The bulk of Sales & Use Taxes (SUT) revenues are from the sales tax on in-state transactions. Use tax remittances of individuals generally are not paid, except for transactions involving products that must be registered, such as a car. If a California resident buys a car in Nevada, for example, he or she must pay the use tax on the purchase price when registering the vehicle in California. For goods that are not registered, the state will collect no use tax unless it is voluntarily remitted by the purchaser, or voluntarily collected and remitted by the remote seller. Historically, voluntarily compliance with the use tax by remote sellers or by individuals has been rare.

Attempts by various states to require a remote seller to collect and remit use tax on merchandise sold to a state’s residents have been restricted by U.S. Supreme Court decisions. In 1967, the Court ruled that collecting use tax on remote sales would place an unconstitutional burden on businesses lacking a physical presence in the state (nexus) because of the complexity of the tax system. Until recently, most remote transactions were from catalog sales and, although states were irritated with their inability to collect use tax, it was not critical to state budgets. With the growth of Internet transactions, however, the incidence of remote sales has increased and is projected to grow dramatically in the near future. The percentage of transactions subject to the sales tax (and mandatory tax collection) is decreasing, while those subject to the use tax (dependent on voluntary remittance) is increasing. The growth of Internet transactions, coupled with the economic shift towards services, has many states worried about the future of sales tax revenues.

Some Commissioners have suggested that better enforcement of the California use tax on remote sales could substitute for joining the Streamlined Sales Tax Project. The Board of Equalization (BOE) has pointed out, however, that the BOE is limited in the measures it can take to collect use tax unless there are changes in federal law. In 2002, the Franchise Tax Board included use tax collection forms and envelopes in 540/540A

* The sales and use tax (SUT) is a tax on final sales of tangible personal property, such as clothing, household furnishings, appliances, and motor vehicles. Intermediate sales of goods are not taxed and certain individual items are specifically exempted. The largest of these tax expenditure programs involve utilities and home-consumed foods. Most services are exempt from direct taxation in California.

booklets. Thus some data could be obtained as to how many use tax remittances were filed. Many individuals do not receive a booklet, however, and those who do could easily overlook the use tax obligation because they do not read the booklet.

Two bills currently in the legislature would improve enforcement of the use tax: SB 1009 (Alpert) adds a line for the use tax on the personal income tax form. Many people are not aware that they are liable for use tax and a line on their income tax form might help with the education process. SB 103 (Alpert) intends to clarify existing law to define when a retailer is engaged in business in this state. It also clarifies that the processing of orders electronically, by fax, telephone, the Internet, or other electronic ordering process, does not relieve a retailer of responsibility for sales tax collection if the retailer is engaged in business in this state.

Another option that would increase use tax compliance would be for the Board of Equalization to pursue individuals who make large, remote-sale purchases for payment of the use tax. Record companies, for example, are currently pursuing individuals who download large quantities of music without paying for them.

Type of Action Required: Regulatory

Balance of State/Local Authority: No impact

| 2. Improve Enforcement of the Use Tax on Remote Sales | | |
|--|---|--|
| Guiding Principle | Pro | Con |
| Fairness | Purchases made remotely (over the Internet or by catalogue sales) should include sales tax. Currently, remote sales have a cost advantage over Main Street sales due to differential tax treatment. | The additional administrative burden to increase compliance may not be cost-effective with respect to the amount of revenue collected. |
| Simplicity | The use tax is already California law. | |
| Efficiency | An existing tax should be enforced and collected. | Without changes in federal law, there are limited measures that can be taken at the state level to collect use taxes. |

3. BROADEN THE SALES TAX BASE TO INCLUDE SELECTED SERVICES AND REDUCE THE SALES TAX RATE

Proposal: Broaden the sales tax base to include selected services, while lowering the rate to retain revenue neutrality. The Commission has heard “Broaden the base and reduce the rate” frequently.

Background: The shift in consumer expenditures from the purchase of goods to the purchase of services continues to raise concerns about the long-term vitality of state and local retail sales taxes, which traditionally are applied primarily to the sale of tangible personal property. In California, sales tax revenues have not kept pace with overall economic growth over the past few decades.

Compared with other states, California taxes only a few services. In its survey of sales taxation of services, the Federation of Tax Administrators found that in 1996, California taxed only 13 of the 164 services surveyed. Other large states taxed more services: Texas (78), New York (74), and Florida (64). The states taxing the largest number of service categories were: Hawaii (157), New Mexico (152), Washington (152), and Delaware (142).

On February 3, 2003, Assembly Members John Dutra and Jackie Goldberg presented the Commission with revenue estimates for the taxation of 36 services. These services, ordered by the size of their 2002-2003 receipts (and therefore potential sales tax revenues), are listed below. Legal services had the highest potential sales tax receipts.

| <i>Proposed Taxation of 36 Selected Services</i> | |
|--|--|
| 1 | Legal services |
| 2 | Engineering, architectural & surveying services |
| 3 | Accounting and bookkeeping services |
| 4 | Hotels/motels lodging |
| 5 | Management, scientific & technical consulting services |
| 6 | Cell phone services |
| 7 | Custom computer programs |
| 8 | Cable TV |
| 9 | Repair labor |
| 10 | Entertainment (admission charges) |
| 11 | Automotive repair services |
| 12 | Security and detective services |
| 13 | Janitorial services |
| 14 | Automotive services |
| 15 | Laundry & dry cleaning services |
| 16 | Custom telephone services |
| 17 | Billiards/bowling facilities |

| <i>Proposed Taxation of 36 Selected Services, continued</i> | |
|---|--|
| 18 | Preliminary art services |
| 19 | Satellite/DBS TV |
| 20 | Moving – intrastate |
| 21 | Landscaping services |
| 22 | Linen and uniform services |
| 23 | Exterminating services |
| 24 | Aircraft/limo charters |
| 25 | Pager services |
| 26 | Swimming pool services |
| 27 | Sale of memberships to private clubs |
| 28 | Funeral services |
| 29 | Telephone answering services |
| 30 | Health Clubs, tanning booths & reducing salons |
| 31 | Marina services |
| 32 | 900 number services |
| 33 | Coin-operated amusement machines |
| 34 | Pet grooming services |
| 35 | Installation charges |
| 36 | Taxidermy services |

More information about the sales taxation of services across states can be found at:
<http://www.taxadmin.org/fta/pub/services/services.html>.

Type of Action Required: Statute

Balance of State/Local Authority: If services were added to state sales tax law, there would not be an automatic addition to the tax base at the local level. Due to Proposition 218, locals will have to vote on and pass an ordinance allowing expansion of the sales tax to selected services.

| 3. Broaden the Sales Tax Base to Include Selected Services and Reduce the Rate | | |
|---|---|---|
| Guiding Principle | Pro | Con |
| Fairness | <p>Historically, most services have been excluded from sales taxation because services are not tangible goods. An ideal sales tax would tax all retail sales once but only once, and at the same rate, to preserve neutrality. Neutrality would also require that the tax system treat the purchase of services in the same manner as the purchase of goods. This ideal sales tax would discourage retail purchases, but would not give a differential incentive to make one purchase over another.</p> <p>Extending the sales tax to services and reducing the rate might reduce sales tax regressivity somewhat. The lower rate would help lower income consumers who tend to have a higher consumption of goods than services.</p> | <p>Some services should not be taxed on equity grounds. Medical care is one oft-cited example.</p> |
| Simplicity | | <p>Many service jobs are provided by small independent contractors who do not have extensive accounting and bookkeeping skills. Keeping track of and collecting sales tax would be difficult for them.</p> <p>Taxing services might give large firms an incentive to provide these services in-house to avoid taxation.</p> |
| Efficiency | <p>The economy is shifting toward the production of services over goods, so a good-based sales tax will not keep up with the state's economic growth. Broadening the base and reducing the rate could result in a revenue-neutral proposal.</p> <p>These changes would decrease consumption distortions and allow for the possibility of decreasing the sales tax rate, which would reduce the excess burden of the tax.</p> | <p>Sales taxation of retail services might be burdensome enough that small independent contractors and small firms might leave the business or evade the tax.</p> <p>The amount of revenue raised by taxing some retail services (excluding health care) would not be worth the hassle.</p> <p>Extension of the sales tax to services such as lawyers and accountants could change incentives for cities. It would not improve incentives to cities to build housing, but might give the cities greater incentives to build office buildings.</p> |

4. ELIMINATE SELECTED SALES AND USE TAX EXEMPTIONS OR EXCLUSIONS

Proposal: Eliminate selected sales and use tax exemptions or exclusions.

Background: Various exemptions and exclusions from the sales and use tax apply to retail sales of tangible personal property. Since the enactment of the Sales and Use Tax Law in 1933, many exemptions have been granted that remove the liability for tax for various types of property and certain individuals or organizations. Other transactions are excluded from the imposition of sales and use taxes because of basic definitions contained in the law or because they do not involve the transfer of tangible personal property.

As an example, the Legislative Analyst's Office recently recommended that the exclusion for custom computer programs be eliminated.* The rationale for this exemption is that custom computer programs consist largely of services delivered to the purchaser, and these services are simply embodied in the software. Since services themselves generally are not subject to the sales and use tax, the theory is that custom computer programs should also be exempt. However, this argument can equally be applied to a variety of other items, most readily to other "off-the-shelf" computer programs, but also to books, musical recordings, and paintings. In fact, any item produced using substantial amounts of labor might also fit this criterion. Eliminating this exemption would result in more consistency in the way that the sales tax is applied.

In 2001, retailers' sales of tangible personal property were exempted or excluded from more than \$8.8 billion of sales and use taxes. The top ten exemption and exclusion amounts claimed in 2001 were:†

| | |
|--|---------------|
| • Residential Energy‡ - exemption | \$3.3 billion |
| • Food Products - exemption | \$3.2 billion |
| • Prescription Medicines - exemption | \$709 million |
| • Animal Life, Feed, Seeds, Plants and Fertilizer, Drugs and Medicine - exemption | \$344 million |
| • Custom Computer Programs – exclusion | \$276 million |
| • Aircraft and Component Part Sales - exemption | \$233 million |
| • Shipping Containers - exemption | \$133 million |
| • Periodicals - exemption | \$74 million |
| • New Mobile homes - partial exemption | \$53 million |
| • Rentals of Linen Supplies - exclusion | \$44 million |

* Legislative Analyst Office, *Options for Addressing the State's Fiscal Problem*, February 2002 http://www.lao.ca.gov/analysis_2002/options/budget_options_2002-03.pdf.

† *State Board of Equalization 2001 – 02 Annual Report*.

‡ This amount does not include sales of energy to commercial users. *Sales and Use Taxes: Exemptions and Exclusions, Publication 61, 2/02*. <http://www.boe.ca.gov/pdf/pub61.pdf>.

More information on sales and use tax exemptions and exclusions can be found at:
<http://www.boe.ca.gov/pdf/pub61.pdf>

Information on recently exempted items, such as liquefied petroleum gas, farm equipment and machinery, diesel fuel, timber harvesting, and racehorse breeding stock, can be found at: <http://www.boe.ca.gov/sutax/sutexempt.htm>.

General information on tax expenditures can be found at:
http://www.lao.ca.gov/tax_expenditure_299/tep_299_contents.html and at:
http://www.dof.ca.gov/HTML/FS_DATA/TAX/TE_Report_2002.pdf.

Type of Action Required: Statute

Balance of State/Local Authority: No impact

| 4. Eliminate Selected Sales and Use Tax Exemptions or Exclusions | | |
|--|---|---|
| Guiding Principle | Pro | Con |
| Fairness | The rationale for an exclusion or exemption can be categorized as a tax incentive to encourage certain behavior and/or as tax relief to certain groups or individuals. Some exclusions might be questionable on the principle of fairness. Moreover, since these exclusions are not reviewed annually in the budget process, exclusions that once might have been “fair” could have outlived their reason for being excluded from taxation. | On grounds of fairness, some items have good reason for being exempt or excluded. Exclusions and exemptions affect the amount of General Fund and special funds revenues raised by the sales and use tax. They also have an impact on local government revenues since (except in certain instances) the programs affect both the state and local portions of sales and use tax receipts. |
| Simplicity | Fewer exemptions and exclusions would simplify sales tax collection and administration. | |
| Efficiency | From an efficiency standpoint, some items are currently excluded for good reason and some are not. | |

TELECOMMUNICATIONS TAXES

5. STATEWIDE COMMUNICATIONS SIMPLIFICATION TAX

Proposal: Combine all state and local taxes, fees and surcharges charged on providers of electronic communications services (e.g. telephone companies, cellular companies, cable television companies, satellite companies) and their customers into one statewide tax on customers' communications bills. This statewide tax would be collected by distributors and allocated by the State Board of Equalization to state and local jurisdictions currently receiving revenues from existing taxes, fees and surcharges on a revenue-neutral basis, meaning that the total amount of revenue collected from all sources under the simplified tax would be essentially equivalent to the amount collected currently.

Background: Digital communication is at the heart of the New Economy. One important result is convergence: the power of monopolies, legal or perceived, is diminishing; providers, which traditionally offered only one service, are now capable of offering multiple services subject to various tax and fee obligations; and, technology is rapidly offering a whole host of new alternatives to providers and consumers. Increasingly, the federal, state and local government regulation of providers and services is put at issue by the deployment of new technologies to meet consumers' desires. Simply put, current taxes, fees and surcharges on communications predate the Internet, or the Internet Tax Freedom Acts. Moreover, no one can reasonably predict future market choices consumers will make and the consequences for state and local taxes and fees. For example, will traditional telephone markets be altered significantly by cellular or Internet Protocol (IP) telephone? Or, will WiFi technology* displace landline broadband market share? Or, what will the impact be of bundling of services by a single provider into a single rate when those services are subject to different taxes and fees at the state and local level?

Old-paradigm taxes, fees and surcharges on communications providers and consumers designed to meet the revenue needs of the State and its political subdivisions - including, but not limited to, franchise fees, utility user taxes, property taxes, and California Public Utilities Commission (CPUC) telephone surcharges - are premised on monopolies offering discreet services with stable technology. They, therefore, cannot insulate the State's revenue base from technological change, competitive choice, or regulatory flux, and call for consideration of structural reform.

As used herein, the term "telecommunications taxes" means property taxes, franchise fees, utility user taxes, and surcharges. The surcharges, which are administered by the Public Utilities Commission (PUC), include charges on rural, low-income and deaf-assistance services, emergency services and PUC reimbursement fees.

Satellite direct-to-home television providers are not subject to any local taxes or fees pursuant to Section 602 of the Federal Telecommunications Act of 1996.

* WiFi, or Wireless Fidelity, is a wireless Local Area Network (LAN) standard that is a fast-growing wireless broadband technology. It is a wireless substitute for landline broadband Internet access like Digital Subscriber Line (DSL) or cable modem services.

Property taxes may be state-assessed or locally assessed, depending on the entity providing the telecommunications services. State-assessed providers are not subject to Proposition 13 protections and are assessed annually at fair market value by the Board of Equalization. Locally-assessed property is assessed by county assessors and because it is protected by Proposition 13, it will potentially enjoy lower assessed valuation than fair market value.

Franchise fees are imposed on gross receipts by local governments for use of local rights-of-way and for the right to do business.^{*} Telephone companies are not subject to franchise fees, but cable television providers are subject to such fees.[†]

Utility user taxes (UUT) are imposed by cities or counties on residential and commercial users of utilities, including telephone services and cable television services. These taxes are usually imposed at a fixed percentage of the cost of the service, although some local jurisdictions have low-income or senior-citizen reductions or exemptions.

PUC-administered surcharges were first authorized in 1983 by the Moore Universal Telephone Service Act.[‡] The Act authorized up to a four-percent tax on intrastate telephone service to fund what has grown into three programs: the Universal Lifeline Trust Surcharge (providing subsidized minimum monthly service for low-income persons); the California High Cost Fund Surcharge (a subsidy to customers of smaller local exchange carriers) and the Deaf Equipment Acquisition Trust Fund (a subsidy to companies for the cost of providing telephone services to deaf or hearing disabled customers). Other surcharges include the Emergency Telephone Users Surcharge, which provides funding to local government for the state-mandated 911 systems,[§] and the PUC Reimbursement Fee.^{**} These two surcharges are also imposed as a percentage of the cost of intrastate telephone service.

Florida is an example of one state that has already put a simplified communications tax in place,^{††} but their experience demonstrates that structural reform is a time-consuming process. It took Florida two years for the state government, local government, industry, and other interested parties to agree on the final form of legislation. Moreover, any such reform cannot take place at the cost of important state policies such as safety (i.e.: 911 support) and universal service.

One suggestion before the Commission is that consideration of a single statewide telecommunications tax should be coupled with a dedication to statewide infrastructure, including accelerating the deployment of broadband.

^{*} Public Utilities Code sections 6001 et seq. and 6201 et seq.

[†] Public Utilities Code section 7901, *County of Los Angeles v. Southern California Telephone Company* (1948) 32 Cal. 2d. 373 and the California Government Code section 53066.

[‡] California State Statutes, 1983, Chapter 1143.

[§] Revenue and Taxation Code section 41030.

^{**} Public Utilities Code section 431.

^{††} Florida Communications Services Tax Simplification Law, Taxation and Finance Code, Title XIV, Chapter 202.

For more information on telecommunications taxes in California: James E. Prieger, Terri A. Sexton, and Annette Nellen, *The Taxation of Telecommunications in California in the Information Age*, Berkeley: California Policy Research Center, Regents of the University of California, 2003, <http://www.ucop.edu/cprc/telecomtaxrpt.pdf>.

Type of Action Required: Statute, Regulation, possible Constitutional Amendment

Balance of State/Local Authority: To the extent that the State moves toward a uniform tax for communications, the issue of the uniformity of the tax base and tax rates will need to be addressed. In similar fashion to the state sales tax where the state has levied uniform rates for distinct purposes, the desire for a uniform rate for communications will need to consider the effects on local tax rates. Options include a maximum permitted local rate (similar to the sales tax) or a state rate that is high enough to establish a subvention to local governments for the revenue lost due to a statewide uniform tax rate. A system with subventions to local governments is likely to be viewed by the local jurisdictions with unease, however. If new local taxes are imposed, approval by the voters would be necessary due to Proposition 218.

| 5. Statewide Communications Simplification Tax | | |
|---|--|--|
| Guiding Principle | Pro | Con |
| Fairness | Ensures that tax differences would no longer play a role in a consumer's decision to choose a provider or technology. | <p>Undermines the system of locally levied taxes on communications.</p> <p>Today, not all cities have a telecom utility users tax. With the State collecting what would be a new tax for some cities, local voters would need to approve the tax due to Proposition 218.</p> <p>The State would need a system to allocate a portion of the tax to local governments.</p> <p>Certain modes of communication may naturally require less regulatory oversight and have less expensive cost structures than other modes of communication. It may not be fair to tax all modes equally.</p> <p>If the state tax weren't coordinated with federal taxes across the different technologies, current disparities might be increased.</p> |
| Simplicity | Permits taxpayers and providers (who collect these taxes) to understand the rules and comply with them correctly, and in a cost-efficient manner. | It is not explicitly stated how funds will be allocated to provide services such as universal service and 911 support. |
| Efficiency | <p>Insulates state and local tax revenues, broadens the tax base, eliminates multiple tax filings, and gives providers the greatest flexibility to deploy technologies and services with certainty as to the burdens associated with such offerings. This will encourage investment in California infrastructure and customer choice.</p> <p>Deployment of the most efficient technologies and elimination of consumption distortions.</p> | Current locally levied taxes on communications might be replaced by state subventions, which might disappear during periods of economic downturn. |

6. DIRECT BROADCAST SATELLITE TAX

Proposal: Impose a statewide eight-percent tax on Direct Broadcast Satellite (“DBS”) service that approximates the tax and fee burden on cable television operators and subscribers.

Background: Currently, the DBS industry has over 1.6 million California subscribers and almost 20 percent of the multi-channel video market. DBS companies generate gross revenue of over \$1.5 billion in California. Neither DBS companies nor subscribers pay CPUC surcharges and taxes, franchise fees, and utility user taxes. By contrast, cable TV operators, who are direct competitors to DBS, and eight million Californians who subscribe to cable pay over \$300 million in local taxes, utility fees and local franchise fees on revenues of \$3.8 billion. For cable companies, this amounts to paying an average of eight percent of their revenues in franchise fees, property taxes, and utility user taxes to local governments.

A DBS tax is consistent with the Commission’s charge under Revenue and Taxation Code Section 38065. Under federal law, the State may, and local government is prohibited from, imposing a tax on DBS.* California added Part 15 to the Revenue and Taxation Code many years ago to ensure tax parity between cable companies and other providers, but that code has not been amended to keep pace with the DBS industry. Fourteen other states, including Florida and Texas, tax DBS service at rates ranging from four percent to 13.17 percent.

Type of Action Required: Statute

Balance of State/Local Authority: To the extent that the State moves toward a uniform tax for communications, the issue of the uniformity of the tax base and tax rates will need to be addressed. In similar fashion to the state sales tax where the state has levied uniform rates for distinct purposes, the desire for a uniform rate for communications will need to consider the effects on local tax rates. Options include a maximum permitted local rate (similar to the sales tax) or a state rate that is high enough to establish a subvention to local governments for the revenue lost due to a statewide uniform tax rate. A system with subventions to local governments is likely to be viewed by the local jurisdictions with unease, however.

* See section 602(c) of the Federal Telecommunications Act of 1996.

| 6. Direct Broadcast Satellite (DBS) Tax | | |
|--|---|---|
| Guiding Principle | Pro | Con |
| Fairness | <p>A tax on subscribers that is collected by DBS operators through subscribers' bills would provide for transparency and visibility by delineating that the tax exists, and how and when it is imposed upon them and others.</p> <p>Like currently existing sales-and-use taxes, it can be structured to minimize non-compliance.</p> <p>Most importantly, a tax on DBS provides competitive neutrality in an important area of the new economy by balancing the burdens between providers of multi-channel video service. Tax differences would no longer play a role in a taxpayer's decision to choose cable or DBS.</p> | <p>The proposed DBS tax attempts to create regulatory parity between cable and DBS providers, but it ignores other technologies, such as telephone services (broadband and standard services), which are substitutes for cable and DBS services.</p> <p>Certain taxes may apply only to certain technologies (e.g. local taxes for cable, federal taxes for orbital spectrum for satellite). A tax on DBS that equals taxes on cable may penalize a more efficient technology.</p> <p>How do federal taxes on DBS play into the proposed equalization of the burden between cable and DBS at the state level?</p> |
| Simplicity | <p>A tax paid by a subscriber at the time of payment of a DBS bill will be at a time or in a manner that is most likely to be convenient for the taxpayer.</p> <p>It will also permit taxpayers to understand the rules, and comply with them correctly and in a cost-efficient manner.</p> <p>Collection by the DBS provider and remittance to the State will keep collection costs to a minimum for both the government and taxpayers.</p> | <p>Creates a new tax rather than incorporating it into the current tax structure.</p> |
| Efficiency | <p>A tax that equalizes the burden between cable and DBS will give the State a reliable revenue base: migration of customers to DBS will no longer result in decreased revenues because, even if local governments are losing tax and fee revenues, the State tax will neutralize any overall revenue reduction.</p> <p>A DBS tax will also promote economic growth by encouraging competition based on innovation and consumer satisfaction, not tax and fee differential.</p> | <p>Requires a structure to be set up to administer the tax.</p> <p>Cable is losing customers to satellite not because of cost disadvantages due to "unfair" tax policy, but because cable companies have raised rates almost 50 percent over the last few years.</p> |

PROPERTY TAX

7. PROPERTY/SALES TAX SWAP

Proposal: Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease the reliance on the sales tax and increase the reliance on the property tax. To do so, the one percent locally levied sales tax rate would be reduced to ½ percent and replaced by an equal amount of property tax.

Background: Under the Bradley-Burns Uniform Local Sales and Use Tax Law, cities and counties are allocated one percent of every retail purchase that takes place within their jurisdictional boundaries. The property tax allocation formula in statute provides a relatively small share of the property tax to cities. Consequently, the only substantial local revenue source over which local jurisdictions can exercise control is the sales tax. This control is exercised through land use decisions. It is argued that this “fiscalization” of land use skews land use decisions toward retail use and away from housing, manufacturing and other uses that do not generate significant sales taxes revenue, but that are necessary for a balanced economy. The fiscal incentives embedded in California’s present system of local government finance lead to endless competition among cities and counties for a finite amount of retail sales tax dollars.

A tax-swap proposal currently being debated in the 2003 Legislature is a bi-partisan measure introduced by Assembly Members Steinberg and Campbell, AB 1221. Details of how such a measure might work are provided on several websites, such as:

<http://www.californiacityfinance.com/>.

<http://www.muniservices.com/Default.asp?SID=3&SSID=45>.

<http://www.hdlccpropertytax.com/ab1221.asp>.

Some observers think that a property-sales tax swap should only be done in conjunction with a revision of current property tax allocation formulas (AB 8).

Type of Action Required: Statute

Balance of State/Local Authority: In one sense, this proposal does not affect the balance of state/local authority since the state is using its current authority to set the state maximum local sales tax rate and allocate the property tax. However, local jurisdictions view the one-percent Bradley Burns sales tax revenue as an important source of revenue and are uneasy with the prospect of swapping it away.

| 7. Property/Sales Tax Swap | | |
|-----------------------------------|---|---|
| Guiding Principle | Pro | Con |
| Fairness | <p>The current system treats potential investors in housing less favorably than similarly-situated retail investors. The swap would make cities less reliant on sales tax revenue. We need a tax system that encourages adequate investment in housing along with investment in retail.</p> <p>The means of distributing sales tax and local government reliance on those sales tax revenues greatly affect the land use decisions of local government.</p> | <p>High-sales-tax cities want to keep in place a system they have made work for them.</p> <p>Schools may not want to see property tax replaced with state general fund money.</p> |
| Simplicity | To the degree that people believe that property tax revenues should be in the hands of local cities and counties, this measure would be a step towards achieving that goal. | While the allocation of sales taxes to local jurisdictions is straightforward (the locals get one percent of taxable sales), the current property tax allocation mechanism is complicated and little understood by most voters. A property/sales tax swap will make the system even more complicated. |
| Efficiency | <p>In the long run, reliance on state-controlled revenues does not provide an appropriate set of rewards and penalties for local government.</p> <p>The tax system is impeding the ability of the economy to produce housing at a time when housing costs are among the biggest challenges for businesses operating in California. Allowing local governments to keep a greater share of property tax revenues, perhaps in exchange for the state keeping an equivalent amount of sales tax or vehicle license fees, would reward the investments local governments make in increasing property values.</p> <p>The swap would also lessen the artificial impetus for promoting retail in lieu of other land uses, especially housing.</p> | |

8. PERIODIC REASSESSMENT OF NON-RESIDENTIAL PROPERTY

Proposal:

Distinguish between residential and non-residential property, and periodically re-assess non-residential property to market value.

Background:

Very similarly-situated businesses that compete with each other and receive the same public services may face widely differing property taxes. In some extreme cases, these differences are as high as ten-to-one per square foot and more. For example, Macy's found its property was taxed higher than its competitors' comparable property in the same shopping center.*

By failing to tax increasing land values, valuable land is kept off the market and speculation in land is encouraged. This leads to inflated land costs for new construction and development. The burden of taxation ends up disproportionately on new investment, which not only pays full market value but also fees, exactions, easements and mitigations, and does not tax those who benefit from the investment of others, that is, the landholders who accumulate untaxed windfall land rents. Taxation of the increased value of land and property, particularly investment property, is a relatively neutral and efficient way to tax. It does not affect the investment decision in any way except perhaps positively, that is, it increases the intensity of property utilization, and is a highly efficient, "neutral" tax.

"Change in ownership" statutes and regulations are complicated. As a result of the many complex ways ownership interests can be held and transferred, many transfers of real property are excluded from the definition of "change in ownership" by the Revenue and Taxation Code. Educational materials prepared by the Board of Equalization's staff describe the proper application of "change in ownership" exclusions and also note that taxpayers are sometimes subject to unintentional reassessment as a result of failing to understand the statutory scheme that in some cases authorizes, and in other circumstances prohibits, "two-stage" transactions.

While the proposal for re-assessment increases economic efficiency, there has been a stated concern from the business community about the overall tax burden. Based on efficiency principles, however, the placement of new equipment in service, in manufacturing, or in other investments is taxed both at the sales tax level and at the personal property level. Consistent with these principles, efficiency, simplicity, and fairness could possibly be served by a trade-off, at least in part, with regard to real and personal property tax.

The following website has more information on this proposal:

<http://www.caltaxreform.org/>

* *R.H. Macy & Co. v. Contra Costa County* (1990) 226 Cal. App. 3d 352.

For more information on the assessment of commercial properties in California:
 Brian C. Brown. "Exploring Reassessment of Commercial Properties Owned by Legal Entities," Sacramento: Senate Office of Research, June 2003.

Type of Action Required: Constitutional amendment and implementing statute.

Balance of State/Local Authority:

For the most part, there is little impact on the balance of state/local authority since the rules covering the levy and allocation of *ad valorem* property taxation are held by the state.

| 8. Periodic Re-assessment of Non-Residential Property | | |
|--|--|---|
| Guiding Principle | Pro | Con |
| Fairness | Similarly-situated taxpayers should be taxed similarly. Under the current system, businesses that compete directly with each other may pay widely different property taxes. | If a split roll is passed, costs to commercial and retail businesses will in many cases be passed on to consumers and commercial tenants. |
| Simplicity | Current definitions of "change in ownership" are complex and subject to manipulation. Would reinstate the traditional system for assessing value for property tax purposes. The rules and the methodologies are clear, and, while there are judgment calls, taxpayer compliance is a relatively simple matter. | There will be additional costs involved in recurrent commercial and industrial property inspections and reassessments. Additional staff will need to be hired by county assessors to handle the workload. Assessment Appeals hearings will increase. Under the current system business benefits from knowing the exact annual increases to their tax bills. |
| Efficiency | Our current system inflates the value of land and old buildings at the expense of productive investment. The proposed system with periodic reassessment would send the right incentives to local government for commercial and industrial development as well as for infrastructure. | A split roll could lead to such large increases in property tax that it could force some firms out of business or cause them to leave California. This could cause a reduction in competition, resulting in higher costs to consumers. |

Periodic Reassessment of Non-Residential Property, Alternative Approach #1:

Recommend to the State Legislature that existing “loopholes” be closed, rather than creating a “split roll.” Change in ownership rules are one example. A change in ownership of a legal entity occurs upon acquisition of a majority share of a business’s ownership. This means that minority transfers of ownership (50 percent or less) do not trigger a reassessment, no matter how often they occur, unless a single buyer accumulates a majority share of ownership. Over the past decade, several bills have been discussed in the Legislature to close this type of loophole, but none have passed to date. In the current session, SB 17 addresses this issue.

Periodic Reassessment of Non-Residential Property, Alternative Approach #2:

Periodic reassessment of non-residential property should be considered, provided it is structured to align revenue and responsibility in an innovative approach that will result in the highest-possible return on investment. The following are the essential components of a potentially-workable approach:

- a) Periodic reassessment of non-residential property is done on a cycle that is the average of residential property turnover in the state (perhaps as determined by the State Board of Equalization every decade).
- b) State authorizes local government through each County Board of Supervisors to establish an Infrastructure Investment Fund (perhaps also could be used for affordable housing) that is capitalized by a periodic reassessment of non-residential property, provided it is also endorsed by a majority of the cities representing a majority of the population in the county.
- c) An Infrastructure Investment Commission of reasonable size (perhaps 15 members) is appointed to advise on the investment and expenditure of funds in the Infrastructure Investment Fund, with a majority of the members representing owners of non-residential property who also reside in the county
- d) The Infrastructure Investment Commission must first develop an Infrastructure Investment Plan that is approved by the County Board of Supervisors and a majority of cities representing a majority of the population before any new non-residential assessments can be levied
- e) Infrastructure Investment Plan must be updated periodically (say no less frequently than every 5 years).

LOCAL TAXES

9. CONSTITUTIONALLY PROTECT LOCAL REVENUES

Proposal: Provide a constitutional minimum allocation of property taxes to local governments.

Background: Everyone knows that Proposition 13 limited property tax revenues, but few citizens are aware that it also shifted power over those revenues from local governments to Sacramento. The separation of local responsibility for services from authority over the revenue needed to fund them has led to an unfair and unwise local tax policy. The state's allocation formula attempted to soften the blow of Proposition 13 by freezing 1978 distribution levels. This unfairly rewarded high tax cities and penalized conservative cities.

Under the current system, the amount of property tax collected within a jurisdiction that is returned to that jurisdiction depends to a great extent on the level of government spending in that jurisdiction 25 years ago. Taxpayers in some cities receive ten percent of their money back; taxpayers in other cities receive 25 percent. The state government has all of the power to determine those percentages. However, voters assume that their property tax money is available to their local governments, and they hold local elected officials responsible for local public safety and infrastructure funding.

State officials' responses to complaints from local governments about property tax spending shifts have generally been that local governments should be responsible for raising additional revenues locally. This can be difficult, however. First, local officials are wary of asking for additional local taxes in an environment when existing local revenues are at risk of being taken away by the state. Second, the two-thirds vote threshold for special taxes means that very little opposition is needed to defeat revenue initiatives. In recognition of this, the state recently lowered the threshold for approval of school bonds to 55 percent.

These proposals would provide a constitutional minimum allocation of property taxes to local governments and would empower local officials to raise money for infrastructure, public safety, and other local public investments.

Type of Action Required: Constitutional Amendment

Balance of State/Local Authority: The proposal would prevent the state from reallocating a tax that is locally levied and tax revenue that is allocated to a local government by state statute such as the property tax.

| 9. Constitutionally Protect Local Revenues | | |
|---|--|--|
| Guiding Principle | Pro | Con |
| Fairness | A constitutional minimum allocation of property taxes to local governments could redress the differential distributions of tax revenues and could prevent further shifts of local money from local governments. | The proposal will constitutionally exchange one set of inequities in the local finance system for another. Cities with a narrow tax base and high tax rates would be frozen in the constitution (e.g. cities with a high reliance on the sales tax or utility user tax). |
| Simplicity | A consistent apportionment of property tax revenues to localities throughout the state would be simple and transparent. | The local finance system is currently complex and the local tax payer/voter has little understanding of where the money comes from to pay for services. Placing this system in the constitution will not improve its simplicity or understanding. |
| Efficiency | The current tax system prevents local governments from determining how much revenue will be available and when. That uncertainty interferes with local government's ability to plan for investments that could support the productive capacity of the economy. | |

10. REDUCE THE VOTE THRESHOLD FOR LOCAL TAX MEASURES

Proposal: Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.

Background: Seeking a two-thirds vote for deciding important issues have a long history. A two-thirds vote requirement can be found ten times in the United States Constitution, including the two-thirds vote needed to override a presidential veto or approve a treaty. Similarly, the two-thirds vote appears a number of times in the California Constitution. A legislative two-thirds vote for some tax increases appeared and then disappeared from the California Constitution prior to Proposition 13.

Several vote thresholds are currently in place for local revenues. Tax increases for general taxes need a simple majority to pass. Proposition 13 established the constitutional requirement of a two-thirds vote of the people for raising special taxes. When this provision of Proposition 13 was legally challenged, the California Supreme Court recognized that the initiative's intent for overall tax relief would not be achieved if reduced property taxes could easily be replaced by other taxes. The two-thirds vote of the people to raise taxes to support local general obligation bonds appeared first in the 1879 California Constitution. Currently, all local general obligation bonds except for school bonds require a two-thirds majority to pass. School bonds can pass with a 55 percent majority.

Type of Action Required: Constitutional Amendment

Balance of State/Local Authority: Lowering the vote threshold on local special taxes would make it easier for local government to raise local revenues and would increase local authority.

Other Related Proposals:

Related proposals discussed by the Commission include:

1. Lower the vote threshold for voter-approved local bond measures for purposes other than education bond measures, which are now at 55 percent.
2. Flip the two-thirds approval now required for "special purpose" local tax revenue measures and apply it to "general purpose" revenue measures. The simple-majority approval now required for general purpose revenue measures would then be applied to special purpose tax revenue measures. The vote threshold should be lower for special purpose revenue measures because voters and taxpayers by definition have more say and control over special purpose revenues measures.

| 10. Reducing the Vote Threshold for Approval of Local Tax Measures | | |
|---|---|--|
| Guiding Principle | Pro | Con |
| Fairness | <p>One “No” vote should not offset two “Yes” votes.</p> <p>It has also been argued that any requirement authorizing a vote of the people interferes with the ability of government officials to manage local budgets effectively.</p> | <p>The two-thirds vote is an established and recognized device in democratic government.</p> <p>The two-thirds vote standard offers some sense of consensus on tax-raising issues, particularly when off-time elections have low voter turnout. Under a majority vote standard, a tax on all the people could be raised by, say, the five percent of registered voters who vote at a low turnout election.</p> |
| Simplicity | | |
| Efficiency | <p>Infrastructure improvements would provide economic benefits to local jurisdictions.</p> | <p>A lower vote requirement for general and special taxes most probably would quickly lead to heavier tax burdens.</p> |

OTHER TAX POLICY OPTIONS

11. STATE TAX COURT

Proposal: California should establish a state tax court to resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes.

Background: Proposals to form a state tax court have been discussed in California over the last 30 years. According to advocates of establishing a state tax court, the current system for both the administrative and judicial resolution of tax disputes in California does not provide a fair, reliable, or efficient means of resolving tax disputes, especially in comparison to the procedures available to resolve federal tax disputes.

Type of Action Required: Statute and Constitutional Amendment.

A constitutional amendment would be needed if property tax were to be handled by the proposed state tax court instead of local assessment appeals boards for locally assessed property and instead of the Board of Equalization for Section 11 property.

Balance of State/Local Authority: No impact.

| 11. State Tax Court | | |
|----------------------------|---|---|
| Guiding Principle | Pro | Con |
| Fairness | <p>The highest forum to which most taxpayers can pursue their tax appeals without payment of tax, interest, and penalty is the State Board of Equalization. Board members serve for limited terms and are not trained specialists in tax law.</p> <p>With certain limited exceptions, an administrative resolution of disputes does not take into account the “hazards of litigation.” This factor, when objectively applied by independent tax resolution specialists, encourages the settlement of tax disputes. Instead, for many taxes, California maintains an all-or-nothing policy thereby forcing taxpayers to concede the entire amount in dispute or pursue litigation.</p> | <p>California already has a tax court that is open to the public and that is directly accountable to the voters. It’s called the Board of Equalization (BOE), though perhaps the Board’s name should be changed to the California State Tax Commission. Both the BOE and the Franchise Tax Board have settlement programs, affording taxpayers the opportunity for administrative resolution with a staff of trained accountants, auditors and attorneys. In addition, taxpayers may take their case to a public hearing before the elected Members of the Board of Equalization. Each of the 5 members is advised by an independent staff of trained accountants, auditors, and attorneys, but unlike Tax Court judges, they are accountable to the voters.</p> |
| Simplicity | <p>There is no practical judicial alternative to dispute resolution. In the federal system, taxpayers who are unable to settle with the Internal Revenue Service are afforded the opportunity to present their case to the United States Tax Court without paying any tax, interest, or penalty. In contrast, the resolution of most tax disputes in California in Superior Court requires the payment of tax, interest, and penalty in full before the Court can have jurisdiction. As a practical matter, this requirement deprives most California taxpayers of any judicial resolution.</p> <p>Additionally, the judges of the United States Tax Court are trained and experienced in tax law. In contrast, virtually all Superior Court judges have no particular tax expertise.</p> | <p>With a few exceptions, specialization of the judicial system has been avoided in California on the basis of cost and the theory that it will reduce the flexibility of the judiciary to meet changing needs.</p> <p>The issue of pre-resolution payment of tax liabilities can be addressed without replacing the Board of Equalization with a Tax Court (then-Speaker Hertzberg introduced a bill to allow posting of a bond as an alternative to payment). The Tax Court proposal would take only tax cases away from Superior Court judges, even though there is no requirement that Superior Court judges have any particular legal specialization.</p> <p>The current system gives taxpayer an opportunity for a three-part resolution: (i) before the agency staff in the settlement programs; (ii) before the elected Board of Equalization; and (iii) in Superior Court, if the taxpayer chooses to pay the liability in full before suing for a refund.</p> |
| Efficiency | <p>The publication of decisions by the United States Tax Court provides a growing body of judicial precedent that can serve as guidance to all taxpayers. In contrast, California has a very limited number of published decisions on tax disputes.</p> | <p>The Board of Equalization publishes decisions on tax disputes. There is no need to create an unaccountable new agency primarily for this purpose.</p> |

12. FLAT-RATE TAXES

Proposal: Eliminate all current taxes in California except for “sin taxes,” such as cigarette and alcohol taxes, and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.

Background: Dr. Arthur Laffer presented this proposal to the Commission by on April 23, 2003. His proposal can be viewed on the Commission’s website at:
<http://www.canewconomy.ca.gov>.

The revamped tax structure with a six-percent tax rate for both taxes would replace, on a revenue neutral basis, the \$120-billion now generated by California’s state and local taxes.

A flat-rate tax applies a single tax rate equally to all sources of income, and that rate does not change as a result of the taxpayer’s volume of income. All other taxes should be repealed. In their place would be two flat-rate taxes of equal rates on personal unadjusted gross income and on business value-added. There should be one and only one tax for people and businesses to pay.

Despite the seemingly uncomplicated nature of the theory behind the flat tax, practical application requires some unavoidable complications.

For example, mortgage interest rates have to remain deductible as long as interest income is taxable. If someone borrows \$100,000 at seven percent and lends \$100,000 at seven percent clearly that person should not be liable for taxation. That person is simply a conduit for a loan. And yet if a person borrows \$100,000 at seven percent and lends \$100,000 at ten percent, then that person should be liable for taxation on the difference. All interest income should be taxable and all interest expense should be deductible. To avoid fraud and manipulation, for individuals interest deductions should be limited to mortgage interest.

Homeowners effectively rent from themselves with pre-tax dollars. Renters, on the other hand, pay their rent in after-tax dollars. Therefore, to be kept on an even footing with homeowners, renters should be allowed to deduct rent on their primary residence from their overall tax base. No longer would there be an economic distortion between home ownership and renters. Allowances should also be made for personal charitable contributions.

“Sin taxes,” such as excise taxes on cigarettes and alcohol, exist both to raise revenue and to discourage certain behaviors. These “sin taxes” would need to remain in place along with fines, penalties, etc.

For business value-added there shouldn’t be any specific deductions other than all purchases from other companies. One unusual feature of business value-added under the flat-tax is that all purchases from other companies—including capital equipment—would be expensed when purchased. This has the effect of leaving undepreciated capital on the

books of firms. Therefore, during a transition period this proposal would allow businesses to continue their depreciation over time, leaving the tax rate a little higher than it otherwise would be.

Starting with personal income and gross product as the base measures for the personal income tax base and business value-added tax base, respectively, the appropriate adjustments are made as discussed above to arrive at approximations for both tax bases.

The appropriate flat tax rate is obtained by dividing targeted revenues by the total tax base. Dr. Laffer's analysis for FY 1987 suggested that the business value-added tax base was a little larger than the personal income tax base, resulting in a recommended flat tax rate of slightly less than six percent on both the business value-added tax base and the personal income tax base. These calculations have been updated through FY 2000 using the most current state and local data available. To raise the targeted level of state and local revenue, the required flat tax rate on the personal income tax base and the business value-added tax base has ranged between 5.81 percent and six percent. Therefore, a six percent flat rate would be more than enough to achieve the necessary state and local tax revenues.

Other practical considerations, including the allocation of revenue between state and local government, can be found in Dr. Laffer's FY 1987 analysis.

This flat-tax proposal is designed to minimize the disincentives induced by tax rates and yet still provide the requisite amount of revenues to provide the services Californians want and need. This revenue-neutral proposal will, by definition, raise the same amount of revenue as the current system.

Type of Action Required: Constitutional amendment and implementing statute.

Balance of State/Local Authority: This proposal would establish a set of uniform rates that would pre-empt local taxation. Local authority to increase/decrease levels of local taxation to meet increases/decreases in local services would be limited.

| 12. Flat Rate Taxes | | |
|----------------------------|---|---|
| Guiding Principle | Pro | Con |
| Fairness | <p>The tax is uniform, meaning that all taxpayers' pay the same rate and are treated the same.</p> <p>Reducing the number of deductions for income tax payers, but allowing both a deduction for rent as well as mortgage payments, would help ensure equitability.</p> | <p>Those who believe in progressive rates believe rates should be based on ability to pay.</p> |
| Simplicity | <p>Individuals and businesses would be aware of their income tax or value-added tax liability, and with reduced deductions could easily figure out their tax obligation.</p> <p>This plan is specifically designed to increase tax compliance by having a simple, broad-based, low tax rate for individuals and businesses to comply with.</p> <p>Personal income tax and business value-added tax would be due on a regularly scheduled basis.</p> | <p>Methods of distribution of revenues to local jurisdictions would have to be established.</p> |
| Efficiency | <p>The cost of complying for the income tax payer should not change from the current situation.</p> <p>By reducing the income tax to one rate and simplifying or eliminating deductions and credits, the current income tax system would be simplified. Moreover, the extent of real simplification will depend on how easy it is to convert federal taxable income to Ca. taxable income.</p> <p>By lowering the top personal income tax rates, concerns that high-end taxpayers will leave the state to avoid excessive taxation should end.</p> <p>This flat tax system is designed to create dynamic change for the economy, bringing in more revenue soon and into the future.</p> | <p>Business may react to the value-added tax provisions by bringing certain services in-house rather than contracting for those services, thus avoiding a value-added tax on those particular services.</p> <p>Business will need to change procedures to calculate the value-added tax instead of current corporate and personal property tax collection as well as other taxes.</p> <p>The state may not know what to expect in revenue since the income tax is volatile and would make up a larger portion of the tax system than it does presently.</p> <p>The uncertainties of tax calculations could mean that the initial tax collection could be off.</p> |

APPENDIX A: PROPOSED STRUCTURAL REFORMS OF THE STATE BUDGET PROCESS

The current state fiscal structure does not provide for an effective and understandable limitation on state spending, an adequate reserve to meet uncertain economic conditions, a method for rebalancing a budget that is in deficit, and a longer fiscal planning horizon for fiscal policy.

Proposal: Amend the California Constitution to do the following: 1) In order to make the spending limit more transparent, revise it to limit spending based on the prior year level, adjusted for population and economic growth, 2) in order to reduce the fiscal shock of economic downturn, require the maintenance of a reserve, 3) establish a system for rebalancing the state budget when it becomes unbalanced, and 4) initiate a fiscal planning requirement that will require the state budget process to plan longer than 12 months. Part 5 of this proposal describes changes that would foster a “culture of accountability” in the budget process.

1. Revise the current spending limit:

Growth in state general fund spending would be tied to the growth in the state economy and growth in the state’s population. Each budget year would be tied to an index that would approximate the growth in the state economy. Rather than the current limit that grows with personal income with state tax appropriations subject to it, the new limit would be based on the level of spending in the prior year. The prior year budget level would be considered as the “current services” budget. The budget for the following year that is signed by the governor could not exceed the “current services” level as adjusted for population and growth in the economy. It would also take into account constitutional obligations such as the K-14 spending guarantee contained in Proposition 98.

2. Reserve requirement:

Revenue exceeding the spending limit would be placed in a reserve account. The maximum reserve would be 10 percent of general fund spending measured by the prior year general fund expenditure level. Once the 10 percent requirement is met, revenues in excess of the amount needed to fund the budget under the spending limit and to maintain a 10 percent reserve would be available for appropriation for one-time infrastructure spending or one-time tax rebates.

3. Rebalancing an unbalanced budget:

When the state runs a deficit of more than one percent of general fund spending, the following year budget growth would be limited to “current services” as provided in the prior fiscal year, adjusted for case load growth and the amount of spending growth needed to meet the K-14 funding level required by the Proposition 98 guarantee.

4. Multi-year budget planning requirement:

Beginning in an odd-numbered year, require that the governor present a two-year budget plan along with the annual submission of the budget. The spending plan would cover two fiscal years and would provide a two-year spending and revenue blueprint into which the two annual fiscal year budgets would fit. The budget plan would be enacted by statute at the same time that the first annual budget is signed. The spending plan legislation would provide the basis for the second year budget.

5. Foster a “culture of accountability” in the budget process:*

A “culture of accountability” and an “ethic of customer service” must be infused throughout all of government so that taxpayers can better evaluate performance by their representatives. Increased accountability will help taxpayers view government operations not just as expenditures, but rather as “investments” from which they can expect certain “dividends” that benefit them. A public spotlight on outcomes and performance may also foster a greater willingness by taxpayers to “invest” more for particular purposes based on expected results.

- To improve accountability, require the state and all political subdivisions to prepare budgets that delineate measurable goals and objectives.
- To eliminate barriers and promote efficiency, require each county along with all political subdivisions within that county to periodically hold joint hearings (e.g., once every ten years) to determine the fewest number of separate taxing authorities and political subdivisions needed to efficiently and effectively achieve the performance outcomes specified in the collective budgets. Such a plan could be required to be submitted to the voters for approval to increase individual responsibility and accountability. This approach to efficiency is complementary to the concept of a “Community Charter” (as recommended by the Constitution Revision Commission) and ensures that the citizenry has an opportunity to regularly review and engage in the design and structure of government.

Type of Action Required: Statute

Balance of State/Local Authority: Limited impact

* As per the recommendations from the Bay Area Council and the Speaker’s Commission on State and Local Government Financing.

APPENDIX B: COMMISSIONER BIOGRAPHIES

Commissioners Appointed By the Governor:

The Honorable William J. Rosendahl, of Mar Vista, Chairman of the Commission, is the Vice President of Political Affairs for Adelphia Communications. He is also producer, host, and moderator of Public Affairs shows, which feature comments and commentary on the people and issues of the day. Currently, Mr. Rosendahl is Chairman of the California Cable Telecommunications Association and serves on the boards of the California Channel and Cable Positive.

The Honorable Sean O. Burton, of Los Angeles, is the Vice President, Corporate Business Development & Strategy for Warner Bros. Mr. Burton also served in the Clinton Administration on the President's Task Force on National Health Care Reform, in the Office of the Vice President, and with the Democratic National Committee.

The Honorable Larry Carr, of Morgan Hill, is a Council member for the City of Morgan Hill, having been elected in November 2000. Before taking office as a Council member, he served as an elected member of the Morgan Hill School Board. Mr. Carr is the Director of Education and Workforce Preparedness for the Silicon Valley Manufacturing Group. He also serves on the Board of Workforce Silicon Valley and the Industry Initiative for Science and Math.

The Honorable William Dombrowski, of Davis, is the President of the California Retailers Association, a position he has held since 1994. He represents major retail stores, mass merchandisers, major grocery store and drug store chains, and convenience stores. Mr. Dombrowski was appointed by Governor Davis in 1999 to serve on the Industrial Welfare Commission, and serves as its chair.

The Honorable Scott Peters, of San Diego, is a member of the San Diego City Council, having been elected in November 2000. He is a former partner at Peters & Varco LLP, where he represented businesses, local governments and public interest groups on environmental law issues. Mr. Peters is a City Representative on the Metropolitan Transit Development Board and the San Diego Association of Governments' Regional Planning Committee. In 2002, Speaker Wesson appointed Mr. Peters to the California Coastal Commission.

Commissioners Appointed by the Senate Rules Committee

The Honorable Lenny Goldberg, of Davis, is Executive Director of the California Tax Reform Association and owner of a public interest advocacy and consulting firm.

The Honorable Glen Rossman, of San Jose, is Vice President of Cisco's Tax Department. Glen is directly responsible for all income, federal, franchise, sales/use, property, and local county taxes.

Commissioners Appointed by the Speaker of the Assembly

The Honorable Marilyn Brewer, of Newport Beach, is a former member of the California State Assembly, where she created the School Facilities Task Force bringing together community leaders, school officials, and business executives to focus on the need for local school facilities. Prior to being elected to the Assembly in 1994, she was an Executive Assistant to Orange County Supervisor Thomas Riley.

The Honorable William Weintraub, of Los Angeles, is a partner in the law firm of Jeffer, Mangels, Butler and Marmaro, where he specializes in estate and tax planning, as well as client representation in resolution of tax disputes. He is also an Adjunct Professor at the University of Southern California.

APPENDIX C: EX-OFFICIO MEMBERS

Michael Bernick
Director, Employment Development Dept

Honorable Gilbert Cedillo
Chair, Senate Committee on Revenue & Taxation

Honorable Ed Chavez
Chair, Assembly Committee on Revenue & Taxation

Gerald H. Goldberg
Executive Officer, California Franchise Tax Board

Sunne Wright McPeak
Public Member, California Economic Strategy Panel

Honorable Carole Migden
Chairwoman, State Board of Equalization

Steve Peace
Director, California Dept. of Finance

Michael Peevey
President, California Public Utilities Commission

Honorable Steve Westly
California State Controller

APPENDIX D: SPEAKERS BEFORE THE COMMISSION

FEBRUARY 3, 2003: SACRAMENTO

Steve Peace

Director, California Department of Finance

Tal Finney

Director, Governor's Office of Planning and Research

Dr. Clark Kelso

California Chief Information Officer

Dr. Howard Roth

Chief Economist, California Department of Finance

Honorable John Dutra

California State Assembly Member

Honorable Jackie Goldberg

California State Assembly Member

Tom Lieser

Senior Economist, UCLA Anderson Forecast

Steve Levy

Director, Center for the Continuing Study of the California Economy

Doug Henton

President, Collaborative Economics

Honorable Herb Wesson

Speaker, California State Assembly

Honorable Gray Davis

California Governor

Honorable Gilbert Cedillo

California State Senator

Honorable Dick Ackerman

California State Senator

California Commission on Tax Policy in the New Economy

Speakers Before the Commission

FEBRUARY 24, 2003: SACRAMENTO

Honorable Dick Ackerman
California State Senator

Scott Peters
Commissioner

Chris Norby
Orange County Board of Supervisors

Honorable John Campbell
California State Assembly Member

Scott Farris
Governor's Office of Planning and Research

Nick Bollman
President, California Center for Regional Leadership

Jon Coupal
President, Howard Jarvis Taxpayers Association

Honorable Jim Brulte
Minority Leader, California State Senate

California Commission on Tax Policy in the New Economy

Speakers Before the Commission

MARCH 12, 2003: SACRAMENTO

Honorable Phil Angelides
California State Treasurer

Honorable Steve Westly
California State Controller

Charles Collins
Bruce Johnson
Scott Peterson
Streamlined Sales Tax Project

Honorable Martha Escutia
California State Senator

Honorable Debra Bowen
California State Senator

Betty Yee
State Board of Equalization

Elizabeth Hill
California Legislative Analyst

Honorable Joe Canciamilla
California State Assembly Member

Glenn Rossman
Commissioner

Honorable Tom McClintock
California State Senator

California Commission on Tax Policy in the New Economy

SPEAKERS BEFORE THE COMMISSION

MARCH 24, 2003: SAN FRANCISCO

Meeting cancelled

APRIL 14, 2003: LOS ANGELES

Sunne Wright Mc Peak
California Economic Strategy Panel
Ex-Officio Member of the Commission

Dr. Arthur Laffer
President, Laffer Associates

Honorable Antonio Villaraigosa
Former Speaker, California State Assembly

Dave Abel
ABL, Incorporated

Nick Bollman
President, California Center for Regional Leadership

Fred Silva
Senior Advisor, Public Policy Institute of California

Honorable Bob Hertzberg
Former Speaker, California State Assembly

Dan Carrigg
Legislative Representative, League of California Cities

Rusty Hammer
President, Los Angeles Area Chamber of Commerce

Art Pulaski
Executive Secretary Treasurer, California Federation of Labor

Scott Farris
Governor's Office of Planning and Research

California Commission on Tax Policy in the New Economy

SPEAKERS BEFORE THE COMMISSION

APRIL 21, 2003: SACRAMENTO

Annette Nellen

Joint Venture: Silicon Valley Network

Terri Sexton

Center for State & Local Taxation, UC Davis

Fred Silva

Senior Advisor, Public Policy Institute of California

MAY 22, 2003: EL SEGUNDO

Honorable Richard Riordan

Former Mayor, City of Los Angeles

Michael McDonnell

Senior Vice President & Chief Financial Officer, EchoStar

Michael Palkovic

Senior Vice President & Chief Financial Officer, DirecTV

APPENDIX E: LEGISLATION SB 1933 (VASCONCELLOS)

BILL NUMBER: SB 1933 CHAPTERED

BILL TEXT

CHAPTER 619

| | |
|-------------------------------|--------------------|
| FILED WITH SECRETARY OF STATE | SEPTEMBER 24, 2000 |
| APPROVED BY GOVERNOR | SEPTEMBER 23, 2000 |
| PASSED THE SENATE | AUGUST 30, 2000 |
| PASSED THE ASSEMBLY | AUGUST 28, 2000 |
| AMENDED IN ASSEMBLY | AUGUST 25, 2000 |
| AMENDED IN ASSEMBLY | JULY 5, 2000 |
| AMENDED IN SENATE | APRIL 25, 2000 |
| AMENDED IN SENATE | APRIL 6, 2000 |

INTRODUCED BY: Senator Vasconcellos
(Coauthors: Senators Chesbro, Costa, and McPherson)

FEBRUARY 24, 2000

An act to add and repeal Part 18.3 (commencing with Section 38061) of Division 2 of the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

SB 1933, Vasconcellos.

- Taxation and the new economy.
- Existing law provides for various taxes.

This bill would establish, until 2004, the California Commission on Tax Policy in the New Economy. The commission would examine the impact of Internet and other forms of electronic technology on various types of taxes. The commission would be required to submit a report to the Governor and the Legislature on its findings.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. The Legislature finds and declares all of the following:

- (a) With the rapid development of the Internet and electronic commerce, policymakers at all levels of government are confronted with the challenge of

finding ways to encourage this new technology and its impact on our economy continuing to develop prosperously, while addressing the needs for tax equity and assurance that governments at all levels have sufficient revenue to continue providing essential services critical to our economy's continuing growth.

(b) The current national debate on Internet taxation has focused almost entirely on the collection of sales tax on remote sales of tangible products and has produced a myriad of proposals for immediate action that have ranged from allowing states to collect sales taxes on all transactions to imposing a permanent moratorium on any taxes on the Internet.

(c) The Advisory Commission on Electronic Commerce, created by federal law in 1998 to develop "tax and technologically neutral" recommendations, thus far has failed to achieve a two-thirds majority vote on a recommendation that it can send to Congress for a national solution that would apply in all states. Furthermore, the commission's charter did not lead it to examine the critical interrelated policy issues of tax equity and government sustenance.

(d) A roundtable of tax and technology experts that convened recently at the University of California Berkeley School of Information Management and Systems cautioned that "critical decisions about e-commerce taxation should not be made without further neutral and unbiased research." Its report specified several areas for detailed study that relate, not only to sales tax issues, but to technology and consumer behavior in the new economy, as well.

(e) The Legislative Analyst, in a January 2000 report titled "California Tax Policy and the Internet," recommended that the Legislature undertake a comprehensive review of the sales and use tax, as well as telecommunications taxes and the corporate income tax, in relation to e-commerce activity and its impact on tax administration, tax equity, and overall state revenue.

(f) California's current tax structure is largely based on a 20th century industrial economy that produced most of its wealth from manufacturing and agriculture. California's 21st century technology-dependent economy is already based largely on information and services, part of a new global economy that is built on the rapid development of ideas and the exchange of information using multiple communications media. It is characterized by rapid restructuring of business-to-business and business-to-customer relationships in the state and across the world and a shift from production and consumption of tangible goods to use of intangible goods and services.

(g) Numerous reports, including the California Economic Strategy Panel's "Collaborating to Compete in the New Economy" have identified the characteristics of our state's economic transformation at the end of the last century. That report concluded that the state's developing economy is one that is "fast, flexible, global, networked, and knowledge-based." There is a need to reevaluate

our entire system of tax policies and collection mechanisms in light of this new economy. California should lead the way for all states in designing a 21st century tax system.

(h) State and local revenues are generally performing well, based on the state's strong economic performance. This situation provides an opportunity to assure that the tax system performs as well as possible during periods of weaker economic performance, and altogether to assure that sufficient revenues are available for governments to continue providing the services essential for an economy to expand and prosper, by:

- (1) removing inconsistencies and inefficiencies,
- (2) addressing equity and fairness concerns, and
- (3) improving administration, and (4) considering base-broadening measures.

(i) Our tax policies must continue to be formulated in ways that recognize the need for government to provide resources for investment in the infrastructure necessary for economic growth, as well as to provide for the legitimate health, public assistance, and safety needs of our citizens.

(j) It is the purpose of this act to create an open, public, fair, and balanced participatory process for the development of a long-term strategy for revising state and local tax structure for California that eliminates needless complexity and nurtures and expands the state's global leadership in key emerging industries and for businesses that are repositioning to take advantage of the new economy. That policy must balance tax restructuring with the generation of sufficient resources to continuously improve California's educational system, its physical and information infrastructure, its quality of life, and promote shared prosperity.

SEC. 2. Part 18.3 (commencing with Section 38061) is added to Division 2 of the Revenue and Taxation Code, to read:

PART 18.3. CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

38061. This part is known and may be cited as the "California Commission on Tax Policy in the New Economy."

38062. The California Commission on Tax Policy in the New Economy is hereby created.

38063. The commission shall be comprised as follows:

- (a) Nine voting members of the commission, of which three members shall be public members representing business, three members shall be public members representing local government, and three members shall be at-

large members who may represent various segments of the public, including, but not limited to, academia, organized labor, and public interest groups.

(1) The Governor shall appoint five members, taking into consideration the importance of bipartisan representation of public members. The Governor shall designate one of the public members as Chair of the Commission.

(2) The Senate Rules Committee shall appoint two members, including one upon recommendation of the minority party.

(3) The Speaker of the Assembly shall appoint two members, including one upon recommendation of the minority party.

(b) Ex officio nonvoting members shall include all of the following:

(1) The Executive Officer of the Franchise Tax Board, or a designee.

(2) The Chair of the State Board of Equalization, or a designee.

(3) The Director of Employment Development, or a designee.

(4) The Chair of the California Public Utilities Commission, or a designee.

(5) The Director of Finance, or a designee.

(6) The Controller, or a designee.

(7) A public member of the California Economic Strategy Panel to be appointed by the Secretary of Trade and Commerce.

(8) The Chair of the Senate Committee on Revenue and Taxation, or a designee.

(9) The Chair of the Assembly Committee on Revenue and Taxation, or a designee.

38064. The commission may form additional technical assistance workgroups, including experts from government, academia, and the private sector, and interested public stakeholders, as necessary to complete its work.

38065. The commission shall do all of the following:

(a) Identify all the key stakeholders in the new economy and invite them into the commission's process.

(b) Develop a comprehensive agenda of goals and a roadmap of all critical issues that ought to be addressed in achieving a workable, flexible, and balanced long-term solution.

(c) Undertake the process of conducting public hearings and in the correct phases address each of these critical issues and seek to arrive at a comprehensive conclusion with respect to the smartest public policy taxation of the Internet.

(d) Examine and describe all aspects of the current and future California economy, with special attention to the influence of new technologies, including, but not limited to, the use of the Internet in electronic commerce.

(e) Assess the impact of those predictions about the economy on the sources and size of projected public revenues, with special attention to the needs of local government.

(f) Study and make recommendations regarding specific elements of the California system of state and local taxes, including, but not limited to, the following:

(1) With respect to the sales and use tax, the commission shall do all of the following:

(A) Examine the impact that economic transitions have had on the sales and use tax.

(B) Determine whether uneven treatment with respect to the method of sales, the type of commodity, and the location of the buyer and the seller may occur and the extent to which they may have led to tax-generated distortions in economic decision making and disadvantages for certain businesses and economic sectors.

(C) Examine the extent to which the allocation and distribution of sales and use taxes impact local decision making on land use and whether alternative methods may be more appropriate.

(2) With respect to telecommunications taxes, the commission shall examine the status of the current telecommunications tax system, including state telecommunications surcharges, utility user charges, and franchise fees, in light of changes in the competitive and technological features of the industry. This examination should focus on the complexity, consistency, and efficiency of the system.

(3) With respect to income taxes, the commission shall do both of the following:

(A) Examine recent trends in the collection of bank and corporation taxes and the impact that a transitioning economy has had on those trends.

(B) Examine the relationship between the bank and corporation tax and the personal income tax and whether trends in the new economy will have an impact on that relationship.

(4) With respect to property taxes, the commission shall do both of the following:

(A) Investigate the revenue repercussions for local government in assessment of real property, assuming changes in the trends of real property versus personal property utilization.

(B) Examine the effects of electronic commerce activity on land-based enterprises in the new economy and evaluate the impact on local economic development approaches and consider what new tools could be used.

38066. The commission shall submit an interim report to the Governor and the Legislature not later than 12 months from the date of the commission's first public meeting and a final report with recommendations not later than 24 months from the date of the commission's first public meeting.

38067. This part shall remain in effect only until January 1, 2004, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2004, deletes or extends that date.